

# Joint Oil and Gas Operations in Louisiana

Guy E. Wall

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*Guy E. Wall\**

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## I. INTRODUCTION

Two or more persons often have the right to control the conduct of oil and gas exploration and production activities or share in the costs and profits associated therewith. In Louisiana, these operations, which may be referred to broadly as joint oil and gas operations, arise in three ways: (a) through co-ownership; (b) through orders of the Commissioner of Conservation pooling separately owned tracts; and (c) by agreement. This paper addresses the operating rights and liabilities of the participants in such operations in each of these contexts.

## II. CO-OWNERSHIP

### A. Definition of Co-Ownership

The three basic rights available in Louisiana to explore for and develop oil and gas deposits are ownership of (1) the land, (2) the

mineral servitude and (3) the mineral lease,<sup>1</sup> the latter two being mineral rights which derive from absolute fee ownership.<sup>2</sup> Each of these rights is susceptible of co-ownership, a relationship which exists between two or more persons who own the same thing in indivision, that is, an undivided share of the whole.<sup>3</sup>

From this requirement of common ownership of the same thing, it follows that co-ownership does not exist between the owner of the land and the owner of a mineral right in the land or between the owners of different mineral rights in the same property, e.g., between the owner of a mineral servitude and the owner of a mineral lease thereon.<sup>4</sup> It also follows that the owner of a mineral right obtained from a co-owner of land will not be in co-ownership with the owner of a mineral right obtained from a different co-owner of the same land. Likewise, the owner of a mineral lease acquired from a co-owner of a mineral servitude is not in co-ownership with the owner of a mineral lease acquired from a different co-owner of the same servitude. In such circumstances, the operating rights of the mineral right owner should be no greater than the operating rights of the interest from which those rights derived.

#### *B. Co-Ownership of Land*

The law of co-ownership of mineral rights derives from the law of co-ownership of land which, in turn, developed by analogy to the law of partnership.<sup>5</sup> However, unlike a partnership, which could only be created by agreement, co-ownership was often created by operation of law, such as in a succession, and courts, quite appropriately, declined to impose fiduciary duties between co-owners.<sup>6</sup> The rights and duties of co-owners,<sup>7</sup> many of which are seemingly opposed to one another, evolved on a case by case basis.

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1. La. R.S. 31:8, 31:21, 31:114 (1989).

2. See George Denégre, *Co-Ownership of Oil & Gas Interests in Louisiana*, 24 Tul. L. Rev. 288 (1950); Edwin K. Hunter, *Co-Ownership Under The Mineral Code*, 22nd Ann. Inst. on Min. L. 137, 138 (1975). Ownership of mineral rights, immovable property such as leases and servitudes, must be distinguished from ownership of actual produced oil and gas, movables that are not owned until they are reduced to possession. La. R.S. 31:6 (1989).

3. La. Civ. Code art. 480.

4. La. R.S. 31:169 (1989).

5. See *Smith v. Wilson*, 10 La. Ann. 255 (1855).

6. See *Emerson v. Shirley*, 188 La. 196, 175 So. 909 (1937).

7. For a general discussion of the rights and duties of co-owners, see *Smith*, 10 La. Ann. 255; George Denégre, *Comment, Ownership in Indivision in Louisiana*, 22 Tul. L. Rev. 611 (1948).

Historically, a co-owner in possession of land was permitted to occupy the property free of rent,<sup>8</sup> and had the duty to care for the property as if it were his own,<sup>9</sup> but he was denied the right to do any work on the property which would alter its character without the unanimous consent of all co-owners.<sup>10</sup> However, the courts generally refused to enjoin a co-owner in possession who wished to make a natural use of the property,<sup>11</sup> such as the cultivation of a plantation.<sup>12</sup> All co-owners participated in the fruits and revenues of an enterprise conducted on the property.<sup>13</sup> The co-owner in possession had the duty to account<sup>14</sup> to the other co-owners for the profit derived from the enterprise and was not entitled to charge for his labor.<sup>15</sup> The remedy of a co-owner who disapproved of such an operation was to apply for a partition of the property.<sup>16</sup> Although a co-owner was liable to another co-owner for expenses necessary for preservation,<sup>17</sup> one co-owner had no liability to a third party for obligations incurred by the other co-owner relative to the property, even for necessary improvements; and where both co-owners contracted with a third party for work on the property, they were liable jointly, not *in solido*.<sup>18</sup> Act 990 of 1990, effective January 1, 1991, codified these principles in articles 797-818 of the Louisiana Civil Code.<sup>19</sup>

### C. Co-Ownership of Mineral Rights

#### 1. Historically

The courts followed the foregoing principles of co-ownership with some deviations in deciding cases involving oil and gas exploration and

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8. *Juneau v. Laborde*, 228 La. 410, 82 So. 2d 693 (1955).

9. E.g., *Southwestern Gas & Elec. Co. v. Liles*, 16 La. App. 500, 133 So. 835 (2d Cir. 1931).

10. E.g., *Cotten v. Christen*, 110 La. 444, 34 So. 597 (1903). Interestingly, the co-ownership rule of unanimity regarding the use of real property developed by analogy to the now abolished rule that a partner could make no change in real property without consent of the other partners. See La. Civ. Code art. 2870 (1870) (revised and reenacted 1980; source of current La. Civ. Code arts. 2807, 2814).

11. *Denégre*, *supra* note 7, at 615.

12. *Stinson v. Marston*, 185 La. 365, 169 So. 436 (1936).

13. E.g., *Vance v. Sentell*, 178 La. 749, 152 So. 513 (1934) (on rehearing).

14. *Id.*

15. *Conrad v. Burbank*, 25 La. Ann. 112 (1873).

16. *George Denégre*, Comment, Ownership in Indivision in Louisiana, 22 Tul. L. Rev. 611, 613 (1948).

17. E.g., *Moody v. Arabia*, 498 So. 2d 1081 (La. 1986); *Moreira v. Schwan*, 113 La. 643, 37 So. 542 (1904); *Smith v. Wilson*, 10 La. Ann. 255 (1855).

18. *Suthon v. Laws*, 127 La. 531, 53 So. 852 (La. 1910).

19. See Thomas A. Harrell, Co-Ownership in Light of the New Articles of the Civil Code, 38th Ann. Inst. on Min. L. (forthcoming 1991).

production. Although courts repeatedly stated that a co-owner had the right to prevent other co-owners from exploiting the property for oil and gas,<sup>20</sup> in *United Gas Public Service Co. v. Arkansas-Louisiana Pipe Line Co.*,<sup>21</sup> a co-owner whose oil and gas operations on neighboring property were draining the common property requested the court to enjoin another co-owner's drilling operation on the common property, but the court refused.<sup>22</sup> A co-owner's consent to operations was not required to be in writing and could be tacit,<sup>23</sup> but was not alone tantamount to an agreement to share costs.<sup>24</sup>

As soon as oil or gas was severed from the ground it became the joint property of the co-owners.<sup>25</sup> However, a nonparticipating co-owner was not entitled to share in the production until his share of the cost of drilling and completing the well was recouped out of production, even though he had no personal liability for those costs.<sup>26</sup> An operating co-owner could not obtain a money judgment against a nonoperating co-owner for unsuccessful efforts to restore production and was limited to recovering his costs and expenses out of production.<sup>27</sup> An exception existed where these costs were incurred in connection with a well that for several years had provided net returns to a nonparticipating co-owner greater than the costs sought to be recovered.<sup>28</sup>

Co-ownership was distinguished from a nonexclusive mineral right in *Clark v. Tensas Delta Land Co.*<sup>29</sup> In *Clark*, the court held that a mineral servitude covering less than one hundred percent of the minerals

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20. E.g., *Sun Oil Co. v. State Mineral Bd.*, 231 La. 689, 92 So. 2d 583 (1956); *Gulf Ref. Co. v. Carroll*, 145 La. 299, 82 So. 277 (1919).

21. 176 La. 1024, 147 So. 66 (1932).

22. In *Ree Corp. v. Shaffer*, 246 So. 2d 313 (La. App. 1st Cir. 1971), *aff'd*, 261 La. 502, 260 So. 2d 307 (1972), the court suggested that *United Gas* was based upon principles of equity rather than any legal right of a co-owner to utilize the common property.

23. *Connette v. Wright*, 154 La. 1081, 98 So. 674 (1923).

24. See *Sterling v. McKendrick*, 134 So. 2d 655 (La. App. 4th Cir. 1961).

25. See *Allies Oil Co. v. Ayers*, 152 La. 19, 92 So. 720 (1922).

26. E.g., *Huckabay v. Texas Co.*, 227 La. 191, 78 So. 2d 829 (1955); *Allies*, 152 La. 19, 92 So. 720; *Martel v. Jennings-Heywood Oil Syndicate*, 114 La. 351, 38 So. 253 (1905); *Scott v. Hunt Oil Co.*, 152 So. 2d 599 (La. App. 2d Cir. 1963). However, in *Connette*, 154 La. 1081, 98 So. 674, the Louisiana Supreme Court deviated from the cases involving co-ownership of land and, employing the doctrine of implied consent, rendered judgment in favor of an operating co-lessee against a nonconsenting co-lessee for the costs, including a charge by the operating co-lessee for supervision of both producing wells and dry holes, even though the dry hole costs arguably were not incurred in connection with the establishment of production, where the revenues previously paid to the nonconsenting co-lessee exceeded the amount of the judgment.

27. See, e.g., *Freeman v. Depression Oil Co.*, 159 So. 192 (La. App. 2d Cir. 1935).

28. *Southwestern Gas & Elec. Co. v. Liles*, 16 La. App. 500, 133 So. 835 (2d Cir. 1931).

29. 172 La. 913, 136 So. 1 (1931).

acquired from a landowner who, at the time, owned one hundred percent of the minerals, created a nonexclusive, as opposed to a co-owned, mineral servitude. This servitude gave its owner the right to conduct drilling operations without obtaining consent from the landowner.<sup>30</sup> Thus, it is necessary to examine title to determine whether the owner of a mineral servitude or lease covering a fractional interest in the minerals can conduct operations without the consent of others.<sup>31</sup>

## 2. *The Mineral Code*

### a. *The Right to Conduct Operations*

The Mineral Code of 1974 codified some of the foregoing judicial principles of co-ownership applicable to oil and gas exploration and presumably left the remaining ones in place. As originally enacted, the Mineral Code required unanimous consent of all owners for a co-owner of mineral rights to conduct operations unless the co-owner was acting to prevent waste.<sup>32</sup> In *GMB Gas Corp. v. Cox*,<sup>33</sup> the court applied the Mineral Code requirement of unanimous consent to facts arising prior to its enactment and enjoined a co-owner from conducting oil and gas operations. Though the Mineral Code did not explicitly grant a co-owner of land the right to act to prevent drainage or waste, most commentators have concluded that this was an oversight and that the co-owner of land does possess such a right.<sup>34</sup> The Mineral Code preserved

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30. See also *Steele v. Denning*, 456 So. 2d 992 (La. 1984); *Cox v. Sanders*, 421 So. 2d 869 (La. 1982); *Starr Davis Oil Co. v. Webber*, 218 La. 231, 48 So. 2d 906 (1950).

31. The concept of nonexclusive mineral servitudes creates an interesting theoretical paradox: when a landowner who granted a nonexclusive mineral servitude sells the property and reserves all or part of the minerals, does he thereby acquire a nonexclusive servitude? Immediately prior to the sale, two persons had the right to explore and produce: the landowner and the servitude owner. If the landowner's sale with a reservation of the minerals is viewed as a reservation of what he already owns, then after the sale he also has a nonexclusive mineral servitude. On the other hand, if the sale with a mineral reservation is viewed as the vendee's grant of a mineral servitude, then the vendor does not have a nonexclusive mineral servitude nor an independent right to explore for or produce oil and gas. Since a landowner cannot create a mineral servitude on his property in his own favor, the servitude reserved in an act of sale does not come into existence until after title passes. Accordingly, the vendor in the foregoing hypothetical who reserved the minerals would not acquire a nonexclusive servitude and would have no right to operate without the consent of the owner of the nonexclusive servitude, who, ironically, could operate without the former's consent.

32. A co-owner acting to prevent waste cannot intentionally interfere with another co-owner's operations. *Auster Oil & Gas, Inc. v. Stream*, 764 F.2d 381 (5th Cir. 1985).

33. 340 So. 2d 638 (La. App. 2d Cir. 1976).

34. See, Hunter, *supra* note 2, at 143-44; John M. McCollam, A Primer for the Practice of Mineral Law Under The New Louisiana Mineral Code, 50 Tul. L. Rev. 732, 848 n.760 (1976).

the right of a co-owner of mineral rights to demand a partition<sup>35</sup> and, the comments imply, a continued distinction between a co-owned mineral right and a nonexclusive one.<sup>36</sup>

Effective January 1, 1987, Mineral Code articles 164 and 166 were amended to permit one who acquires a mineral servitude or lease from a co-owner of land to conduct operations if he has the consent of co-owners owning at least an undivided ninety percent interest in the land.<sup>37</sup> Article 175 was also amended to permit a co-owner of a mineral servitude to conduct operations so long as he has the consent of the co-owners owning at least an undivided ninety percent interest in the servitude.<sup>38</sup> However, these amendments were short lived.

Act 647 of 1988, effective January 1, 1989, amended Mineral Code articles 164 and 166 again, this time to permit the owner of a mineral servitude or lease acquired from a co-owner of land to conduct operations thereon if consent was obtained from those owning an undivided eighty percent interest in the land, provided that every effort was made to contact all owners and offer them the same contract.<sup>39</sup> Mineral Code article 175 was similarly amended to grant the same rights to the co-owner of a mineral servitude.<sup>40</sup> However, no similar rights were granted to a co-owner of a mineral lease who must still obtain the unanimous consent of the remaining co-owners to conduct operations other than to prevent waste, destruction or termination.<sup>41</sup>

Where the mineral right was derived from a co-owner, the mineral right owner should have no greater rights to explore for or produce minerals than the co-owner.<sup>42</sup> For example, where co-owners of the same mineral servitude each execute a mineral lease in favor of a different party, the relative operating rights between the resulting lessees will be determined by the law of co-ownership of mineral servitudes, not by

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35. La. R.S. 31:172 (1989).

36. *Id.* 31:169 & comment.

37. 1986 La. Acts No. 1047, § 1 (act approved July 17, 1986, amended 1988).

38. *Id.*

39. La. R.S. 31:166, 31:175 (1989). An argument can be made that Mineral Code articles 164, 166 and 175 permit operations with less than eighty percent interest consenting. These articles literally require only that the servitude owner or lessee has made every effort to contact *such* co-owners, which, arguably, is a reference to "co-owners owning at least an undivided eighty percent interest in the land." Reading the word "provided" to mean "unless," the act then takes on an entirely different meaning: the co-owner of a mineral servitude, or one who acquires a servitude or lease from a co-owner of land, may exercise that right as long as he has made every effort to contact the owners of eighty percent of the land or servitude and has offered to contract with them on substantially the same basis.

40. La. R.S. 31:175 (1989).

41. *Id.* 31:177.

42. See Hunter, *supra* note 2, at 138 n.6; but see Thomas A. Harrell, Problems Created By Co-Ownership in Louisiana, 32nd Ann. Inst. on Min. L. 379, 426-27 (1985).



the law of co-ownership of mineral leases. Each lessee can exercise his lessor's right to veto operations and neither lessee can operate without the other's consent unless one of them has met the requirements of Mineral Code article 175.<sup>43</sup>

Professor Harrell has suggested that where two co-owners of land lease their lands to two different persons, each lessee is free to conduct operations without anyone's consent.<sup>44</sup> He reaches this conclusion by arguing that when the co-owner of land creates the lease he consents to a general devotion of the land to mineral purposes. Furthermore, the argument goes, neither lessee can object because the right to explore for the minerals does not carry with it the right to prevent anyone else from doing the same. This analysis is suspect for two reasons. First, consent to one type of operation, or any activities by one party, does not imply consent to all operations by any party. Second, inherent in the right to explore for and produce minerals is the right to determine the fashion in which the exploration and production takes place. Professor Harrell is correct in stating that a co-owner of land who has leased his interest has no right to object to the operations conducted by a lessee of another co-owner; however, the lessee of the aforementioned co-owner, who has derivatively acquired the landowner's rights, may veto the other lessee's operations in order to protect his right to determine the fashion in which the property is developed.

*b. The Right to Recover Costs*

A co-owner of land or of a mineral right, acting to prevent waste, may recover the costs of those operations out of production.<sup>45</sup> Although the Mineral Code makes no provision for cost recovery by a co-owner not acting to prevent waste, the courts nevertheless have held that a nonparticipating co-owner cannot share in production until the operating co-owner has recouped his expenses.<sup>46</sup> Indeed, the operating owner of a mineral lease granted by a co-owner of land may retain one hundred percent of the proceeds of the well while recouping expenses to the prejudice of the other co-owner of the land.<sup>47</sup>

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43. See *supra* text accompanying notes 39-40. Where the first lessee has an eighty percent ownership interest under the lease and the other lessee has the remaining twenty percent, it may be argued that the first lessee need make no effort to contact the other lessee because it would be a vain and useless act.

44. Harrell, *supra* note 42, at 427-28.

45. La. R.S. 31:164 (land), 31:166 (land), 31:175 (servitude), 31:176 (servitude), 31:177 (lease) (1989).

46. *Grace-Cajun Oil Co. No. 3 v. FDIC*, 882 F.2d 1008 (5th Cir. 1989); *Willis v. International Oil & Gas Corp.*, 541 So. 2d 332 (La. App. 2d Cir. 1989).

47. *Willis v. International Oil & Gas Corp.*, 541 So. 2d 332 (La. App. 2d Cir. 1989).

Mineral Code articles 164 and 166 provide that a co-owner of land who does not consent to mineral operations will have no liability for the costs of development except out of his share of production. Mineral Code articles 175 and 177 contain a similar provision regarding mineral servitudes and mineral leases. However, the converse should not be true; mere consent to the activities of a co-owner should not be equivalent to an agreement to participate in those activities and to bear a share of their costs.<sup>48</sup>

The comments to Mineral Code article 177 suggest that, in spite of the article's literal wording, a nonparticipating lease co-owner could be liable for the costs of a well in advance of production where it made a demand, although no effort was made to specify the kind of demand that would result in liability. Undoubtedly, this is an effort to respond to the inequity of allowing a lease co-owner to share in production without taking risks. However, there is no logical reason why a demand in and of itself should trigger liability for exploration and development costs, because a person with a legal right to something should also have the right to demand it. A better solution is to amend Mineral Code article 177 to provide that a co-owner of a lease or a lessee of a co-owner wishing to participate in the production from a well must pay his pro rata share of the costs or suffer a risk charge.<sup>49</sup>

### III. UNITIZATION

#### A. *The Right to Conduct Operations*

The Commissioner of Conservation has statutory authority to require "owners," defined as persons with the right to drill, produce and appropriate production,<sup>50</sup> to pool their interests in a drilling unit to prevent waste or to avoid drilling unnecessary wells.<sup>51</sup> The Commissioner also has broad power to regulate oil and gas exploration and production.<sup>52</sup> However, the unitization statutes do not explicitly grant any greater rights to conduct operations than those granted by the Mineral Code, which would deny the operator of the unit the right to conduct operations on a unit tract unless he had a real right in it, such as ownership, a servitude or a lease. Thus, the unit operator would theoretically have no right to drill a well on or under a unit tract without the owner's consent.

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48. Harrell, *supra* note 42, at 393.

49. See *infra* text at notes 65-72.

50. La. R.S. 30:3(8) (1989).

51. *Id.* 30:9(A)(1).

52. See *id.* 30:4, 30:9.

In the landmark case of *Nunez v. Wainoco Oil & Gas Co.*,<sup>53</sup> the Louisiana Supreme Court, noting that the unitization statutes superseded the concept of private ownership of the subsurface, held that the operator had not committed trespass when the unit well unintentionally strayed from vertical and traversed the invisible subsurface boundary onto the plaintiff's property. The court rejected the plaintiff's demand for an injunction ordering the operator to remove the well.<sup>54</sup> In so ruling, the court observed that the Commissioner has "the general authority to establish *whatever* rules, regulations, and orders are necessary to prevent [waste] and to enforce the conservation laws,"<sup>55</sup> and further, that "[u]nitization . . . creates rights and interests in a pool of hydrocarbons beyond the traditional property lines [and] effectively amends . . . private property laws . . . ."<sup>56</sup> In *Exxon Corp. v. Thompson*,<sup>57</sup> the court, relying upon *Nunez*, affirmed the Commissioner's authority to abrogate the rule of capture<sup>58</sup> by requiring that production which occurs prior to the formation of a unit, but after the commencement of proceedings to create one, should be shared on the basis of the subsequently created unit. It remains to be seen how far rights of private ownership will be superseded by the conservation laws.

No statute or case law defines the obligations of the unit operator to the other owners in the unit or the rights of the other owners in the unit well. The other owners in the unit generally are considered to have no control over the operator's conduct of operations, although it has been suggested that the operator's freedom to act may be restricted by a broad fiduciary duty.<sup>59</sup> However, upon application of a nonoperating owner, the Commissioner of Conservation presumably could issue orders regarding the operation of the unit well.

## B. *The Right to Recover Costs*

### 1. *Jurisprudence*

The unitization statute formerly provided that the operator may charge the other interested owners with the actual reasonable expendi-

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53. 488 So. 2d 955 (La.), cert. denied, 479 U.S. 925, 107 S. Ct. 391 (1986).

54. See also *Raymond v. Union Tex. Petroleum Corp.*, 697 F. Supp. 270 (E.D. La. 1988).

55. *Nunez*, 488 So. 2d at 961 (emphasis added).

56. *Id.* at 963.

57. 564 So. 2d 387 (La. App. 1st Cir.), writ denied, 568 So. 2d 1054 (1990).

58. The rule of capture provides that oil and gas, like wild animals, are not susceptible of ownership until reduced to possession. See *Pierce v. Goldking Properties, Inc.*, 396 So. 2d 528 (La. App. 3d Cir.), writ denied, 400 So. 2d 904 (1981).

59. John M. McCollam, *Legal Relations Among Parties to Compulsory Units*, 15th Ann. Inst. on Min. L. 69, 73 (1968).

tures, including a charge for supervision, incurred in developing and operating the unit.<sup>60</sup> Each owner included in the unit was obligated for a percentage share of the drilling costs equal to its percentage share of production from the unit well.<sup>61</sup> While the statute was silent regarding collection of these expenses, in *Hunter Co. v. McHugh*,<sup>62</sup> the court held that the operator could retain all proceeds from production until the costs of drilling, completing and equipping the well had been recouped in a manner similar to the right of a co-owner to obtain reimbursement out of proceeds. However, this was not the only way an operator could obtain reimbursement of costs from an owner in a unit.

In *Superior Oil Co. v. Humble Oil & Refining Co.*,<sup>63</sup> the court held that where a lessee provoked unitization proceedings that resulted in a conservation order including its lease within the unit for the well, the lessee was liable to the drilling party for a pro rata share of the well costs. The court rejected the contention that the operator could only recover costs from production. This divergence from the law of co-ownership rectified the inequity of permitting a nonparticipating lessee to obtain a share of production from a well without taking any of the risks associated with its drilling.

In *Davis Oil Co. v. Steamboat Petroleum Corp.*,<sup>64</sup> the Louisiana Supreme Court held that a lessee which did not provoke the unitization proceeding but did propose a counterplan therein that resulted in its acreage being included in a unit for a proposed well was not liable for its share of the costs of the well. The court reasoned that to rule otherwise would be tantamount to placing a nonoperating co-owner at risk of losing his property to a wealthier operator simply because he exercised his statutory right to propose a counterplan. The court distinguished *Humble* because there the well had already been drilled when the nonoperator provoked the unitization proceedings.

The court's attempt to distinguish *Humble* is unpersuasive and seems more an effort to reach a result than sound legal reasoning. The *Davis Oil* court sanctioned the nonoperator's "defensive" effort to prevent drainage that might possibly occur in the future by proposing a counterplan without incurring any financial obligation. However, in *Humble*, where drainage was actually occurring, the nonoperator owed a duty to his lessor to seek unitization. By fulfilling this duty, he incurred a

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60. 1940 La. Acts No. 157, § 9 (act approved July 12, 1940, repealed 1985).

61. See *General Gas Corp. v. Continental Oil Co.*, 230 So. 2d 906 (La. App. 1st Cir. 1970) (parties who had paid more than their share of the costs were entitled to a refund).

62. 202 La. 97, 11 So. 2d 495 (La. 1942).

63. 165 So. 2d 905 (La. App. 4th Cir.), writ refused, 246 La. 842, 167 So. 2d 668 (1964).

64. 583 So. 2d 1139 (La. 1991).

financial liability for his pro rata share of well costs. This distinction between provoking the proceedings and proposing a counterplan is superficial. The *Davis Oil* court avoided the critical question—whether the exercise of a conservation right, regardless of the nonoperator's financial wherewithal, carries with it the obligation to share costs. The better ruling would have been that it does; an acceptable ruling, overruling *Humble*, would be that it does not. *Davis Oil* accomplished neither.

## 2. *The Risk Fee Statute*

### a. *The Risk Fee*

Even under *Humble*, a nonoperating owner who provoked unitization still incurred only the risk of evaluating the productive life and profitability of the well based upon information obtained after drilling, as opposed to the risk inherent in drilling. To remedy this inequity, the legislature enacted the "Risk Fee" Statute, effective January 1, 1985, which applies in the absence of a contract between owners having tracts in the unit.<sup>65</sup> The statute provides that an owner<sup>66</sup> who has drilled a unit well or intends to drill a unit well may require all the other lease owners in the unit to pay their share of the costs or suffer a risk charge by notifying them by certified mail of: (a) an estimate of the cost of drilling, testing, completing and equipping the well; (b) the location of the well; (c) the objective depth; and (d) all logs, core analyses, production data and well test data from the unit well.<sup>67</sup> The election to participate must be mailed within thirty days of receipt of the initial notice; failure to reply timely constitutes an election not to participate.<sup>68</sup> The operator is obliged to commence the well within 90 days of the nonoperator's receipt of the initial notice, or a new notice must be sent.<sup>69</sup>

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65. La. R.S. 30:10(A)(2) (1989).

66. Presumably, the Mineral Code still governs when a co-owner of a drillsite has the right to drill and, therefore, may be considered an "owner" under the Risk Fee Statute. La. R.S. 30:3(8) (1989). A co-owner of land or the owner of a servitude or lease derived therefrom, or a co-owner of a mineral servitude or the owner of a lease derived therefrom, would have no right to drill, and thus could not be considered an "owner," unless those with an interest in the real right totalling eighty percent consented, or the operation was necessary to prevent waste. See *supra* text accompanying notes 32-40.

The owner of the nonexclusive servitude or lease has the right to drill and produce and would constitute an "owner." See *supra* text accompanying notes 29-30 and 36.

A co-owner of a mineral lease could not be considered an owner unless all co-owners agreed upon the operation or one was acting to prevent waste. See *supra* text accompanying note 41.

67. La. R.S. 30:10(A)(2)(a)(i) (1989).

68. *Id.* 30:10(A)(2)(a)(ii).

69. *Id.* 30:10(A)(2)(a)(iii).

If a lease owner in the unit elects not to participate in the well, or elects to participate and fails to pay his share of costs within sixty days of receipt of a detailed invoice, then, in addition to any other legal remedies, the owner drilling the well may recover the costs of drilling, testing, completing, equipping and operating the unit well, including a charge for supervision, plus a risk charge, out of production.<sup>70</sup> The wording of the statute indicates that the invoice may only be for sums already expended by the drilling owner, i.e., there can be no advance billing for well costs. The risk charge is one hundred percent of the cost of drilling, testing and completing the unit well allocable to the tract belonging to the nonparticipating owner.<sup>71</sup> The cost of equipping the well is not a part of the risk charge.<sup>72</sup>

### *b. Collection of Costs*

Although any owner, including a landowner, servitude owner or lessee, may propose a well under the statute, and thereby potentially collect a risk charge, the risk charge may only be collected out of a lessee's interest in the unit.<sup>73</sup> The lessor's royalty and any overriding royalty attributable to a nonparticipating lease must be paid while the risk charge is being recouped. While the statute does not specify whether the nonparticipating lessee or the drilling owner must pay the royalties, an argument can be made that the drilling owner must pay them because the statute states that the royalty owner shall receive that portion of the "production," not proceeds, due them under the lease.

The Risk Fee Statute preserves the right, established in *Hunter*, of a drilling owner to recoup costs out of production.<sup>74</sup> While the statute preserves other available legal remedies to enforce collection, its wording allows an argument that a drilling owner may now obtain a judgment for costs against a nondrilling owner who provoked a unitization proceeding only after complying with the statutory notice requirements.<sup>75</sup>

### *c. Recoverable Costs*

The Commissioner has jurisdiction to determine unit well costs or depreciated unit well costs,<sup>76</sup> but cannot allocate or enforce collection

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70. Id. 30:10(A)(2)(b)(i).

71. Id.

72. See id.

73. See id. 30:10(A)(2)(e).

74. See id. 30:10(A)(2)(b)(ii).

75. Compare id. 30:10(A)(2)(b)(i) with id. 30:10(A)(2)(b)(ii).

76. La. R.S. 30:10(A)(2)(f) (1989). For an excellent discussion of depreciation, allocation and the amount of unit well costs, see Robert T. Jorden, Unit Well Costs, 14th Ann. Inst. on Min. L. 15 (1967).

of those costs.<sup>77</sup> Prior to the Risk Fee Statute, the Commissioner ruled that where production occurs before unitization, the original well costs are depreciated to the same extent that the unit reserves have been depleted by production prior to unitization.<sup>78</sup> The Risk Fee Statute, as originally enacted, provided that the cost of drilling, testing, completing, equipping, and operating the well should be reduced by the amount of money received from the sale of production prior to the formation or revision of the unit to include nonparticipating tracts.<sup>79</sup> Relying upon that statute, the Commissioner of Conservation ruled that prior production would reduce the costs allocable to the nonparticipating owners only on a dollar for dollar basis, as opposed to a percentage depletion basis.<sup>80</sup>

The question also arose as to whether this was the only way in which the costs allocable to the nonparticipating owners would be reduced. If a well encountered several productive horizons and the deepest were unitized, would the nonparticipating owners in the unit have to bear the entire cost of the well, or would their share of costs be reduced to take into account the fact that they would not participate in the up-hole reserves? The Commissioner of Conservation ruled that the owners of the first unitized pool were responsible for the entire cost of the well.<sup>81</sup> Savvy operators, in an effort to reduce their costs, may be expected to structure their wells to reach at least one sand that can be unitized with other owners in order to take advantage of this rule.

Act 595 of 1991, effective September 6, 1991, amended the Risk Fee Statute to provide that the costs shall be reduced in the same proportion as the recoverable reserves in the unitized pool have been recovered by prior production.<sup>82</sup> A nonparticipating owner is no longer entitled to a dollar for dollar reduction in costs based upon prior production. Thus, even if the operator's well costs have been recovered from prior production, he can compel a nonparticipating lease owner to pay a portion of the costs or suffer a penalty.<sup>83</sup>

The legislature probably did not intend for Act 595 to address the problem of allocating the costs of the well to the owners of the various

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77. *Desormeaux v. Inexco Oil Co.*, 298 So. 2d 897 (La. App. 3d Cir.), writ refused, 302 So. 2d 37 (La. 1974); *Anisman v. Stanolind Oil & Gas Co.*, 98 So. 2d 603 (La. App. 2d Cir. 1957). See also *Superior Oil Co. v. Humble Oil & Ref. Co.*, 257 La. 207, 241 So. 2d 911 (1970).

78. La. Comm'r of Conservation Order No. 125A-1-a (1955). See Jorden, *supra* note 76, at 18.

79. La. R.S. 30:10(A)(2)(c), (d) (1989) (amended 1991).

80. La. Comm'r of Conservation Order No. 860-1 (1990).

81. La. Comm'r of Conservation Order No. 860-1 Supplement (1990).

82. 1991 La. Acts No. 595, § 1.

83. See *id.*

pools encountered by the well. However, the act's literal language seems to address the problem by allowing the operator to recover well costs each time a new horizon in the well is unitized to include owners who have not previously contributed to the costs of the well.<sup>84</sup> A fairer solution would be to allocate costs based upon the relationship between the reserves in the unitized pool and all recoverable reserves in the well.

Another unsettled issue concerns the sale of production related equipment and facilities after production ceases. Traditional concepts of property law suggest that ownership of the land or mineral rights would carry with it ownership of any movable property that becomes incorporated therein, such as tubing in a wellbore, or property dedicated to the production of oil and gas, such as production facilities. Thus, when production ceased, the owner drilling the well would have the right to sell the tubing and facilities for his exclusive benefit. On the other hand, it seems only fair that the proceeds of such a sale be distributed proportionately to all owners in the unit who paid for the well. Arguably, such an equitable result could be achieved through the Commissioner of Conservation's authority to determine depreciated well costs.<sup>85</sup>

#### *d. Unanswered Questions*

There are a number of unanswered questions raised by the Risk Fee Statute. The statute states that the owner drilling the well may recover the costs and the risk charge out of production. However, are the other owners who elected to participate in the well entitled to share in the risk charge? It would seem equitable to permit all parties sharing in the costs of the well to also share in any risk charge.<sup>86</sup> Similarly, does failure to timely pay one invoice, representing a portion of the costs, result in liability for the entire risk charge even where some payments were made? Again, it would seem equitable to calculate the risk charge only upon the unpaid portion of the costs. In addition, will a dispute over the reasonableness of the drilling owner's expenditures toll the sixty-day period in which payment is due? Here, it seems inequitable to subject a participating party to the risk charge because he refused to pay an unreasonable invoice within sixty days. On the other hand, it seems inequitable to permit a participating party to delay paying a

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84. Such a result conflicts with the principle, enunciated in *Desormeaux v. Inexco Oil Co.*, 298 So. 2d 897 (La. App. 3d Cir.), writ refused, 302 So. 2d 37 (1974), that the operator may not recover its costs twice.

85. See La. R.S. 30:10(A)(2)(f) (1989).

86. But see *General Gas Corp. v. Continental Oil Co.*, 230 So. 2d 906 (La. App. 1st Cir. 1970) (mere ownership in unit does not entitle owner to participate in operator's recoupment of drilling costs).



reasonable invoice by invoking procedures to test its reasonableness.<sup>87</sup>

Yet another question arises—must all lease co-owners participate in the well in order to avoid the risk charge? The statute does not specify whether each co-owner of a mineral lease has an independent right to participate, nor whether the risk charge will be reduced to the nonparticipating co-owners' percentage interest in the tract. The statute literally provides that the owner drilling the well may recover, out of production allocable to the tract belonging to the nonparticipating owner, a risk charge, defined as *one hundred percent* of such tract's allocated share of the cost of drilling, testing, and completing the unit well.<sup>88</sup> The fact that the risk charge was defined as the *tract's* allocated share of costs, instead of the owner's allocated share of costs, indicates that the risk charge was intended to be imposed on a tract by tract, as opposed to a lessee by lessee, basis.<sup>89</sup> On the other hand, an argument can be made that a lessee of a tract who has no independent right to drill (either a lease co-owner or a lessee of less than eighty percent of the minerals) has the right to elect to participate in a well because incurring the risk charge constitutes waste.<sup>90</sup> Under these circumstances, the lessee would have to put up all costs allocable to the entire tract but could recover only costs,<sup>91</sup> unless, by such an election, that lessee could be considered a drilling owner with the right to obtain a risk fee.<sup>92</sup> These questions are but a few that might give rise to future litigation.

### C. *Sharing Production/Gas Balancing*

Each owner of a tract in a unit owns a proportionate share of production from the unit well.<sup>93</sup> The operator is obligated to account

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87. Cf. *J-O'B Operating Co. v. Newmont Oil Co.*, 560 So. 2d 852 (La. App. 3d Cir.), writ denied, 565 So. 2d 449 (1990) (party electing to participate in area of mutual interest acquisition not allowed to contest consideration paid by the acquirer).

88. La. R.S. 30:10(A)(2)(b)(i) (1989).

89. Furthermore, a mineral operation conducted on a unitized tract is fictitiously considered to take place on each tract in the unit and so, theoretically, a lessee of a fractional interest in a non-drillsite tract would not have the right to conduct such fictitious operations without the consent of the other lessees.

90. See La. R.S. 31:177 (1989).

91. Allowing a participating lessee of a non-drillsite tract to participate in the risk fee paid by his co-lessee might violate the principles of the Mineral Code that limit recovery to actual costs or expenses. See *id.* & comment.

92. Such an interpretation would create a conflict between the Risk Fee Statute and the notion that a lease co-owner acting to prevent waste must secure the same benefits for his co-owner that he secures for himself. See *id.*

93. See La. R.S. 30:10(A)(1)(b) (1989); *State ex rel. Superior Oil Co. v. Texas Gas Transmission Corp.*, 242 La. 315, 136 So. 2d 55 (1961).

for the production to other owners in the unit.<sup>94</sup> If the unit operator sells oil or gas, then he must share the proceeds with any unleased owner in the unit who has not made arrangements to separately dispose of his share of production.<sup>95</sup> Different rights are accorded to a leasehold owner and to unleased owners who have made arrangements to separately dispose of their share of production.

While oil may be stored in tanks, which facilitates an in-kind division between co-owners, gas, on the other hand, is ordinarily insusceptible of storage, raising unique partition problems. In *Amoco Production Co. v. Thompson*,<sup>96</sup> the court held that the creation of a Commissioner's unit effectively partitioned the ownership of the gas. The court observed that a marketing owner had the theoretical right, if necessary, to sell one hundred percent of the gas produced from the well at any given time, in effect leaving the other owners' share of gas in the ground subject to their right to make up in kind or in cash by applying to the Commissioner for an appropriate order at a later date. However, the court also held that, upon proof that an in-kind partition would result in waste, adversely affect another co-owner's right to recover its pro rata share of production, or adversely affect the correlative rights of the co-owners, the Commissioner had the authority in appropriate circumstances to alter this in-kind partition and order the operator to market gas for the other owners, or balance by cash payments.<sup>97</sup> On appeal after remand, the court affirmed the Commissioner's order that the marketing owners balance takes by payments in cash for the period that the nonmarketing owners were effectively without a market on the ground that such an order was necessary to protect their correlative rights.<sup>98</sup>

#### IV. OPERATING AGREEMENTS

##### A. Introduction

An agreement to share the risk and expense of oil and gas exploration and production is referred to as a "joint operating agreement," or, simply, an "operating agreement." The property covered by such an

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94. *Dixon v. American Liberty Oil Co.*, 226 La. 911, 77 So. 2d 533 (1954); see W. Perry Pearce, *Legal Relations Among Parties to a Unit*, 34th Ann. Inst. on Min. L. 107 (1987).

95. La. R.S. 30:10(A)(3) (1989). See *Taylor v. Woodpecker Corp.*, 562 So. 2d 888 (La. 1990).

96. 516 So. 2d 376 (La. App. 1st Cir. 1987), writ denied, 520 So. 2d 118 (1988).

97. *Id.* at 394-95.

98. *Amoco Prod. Co. v. Thompson*, 566 So. 2d 138 (La. App. 1st Cir.), writ denied, 571 So. 2d 627 (1990).

agreement is referred to as the "contract area." Operating agreements typically designate one party, known as the "operator," to conduct the day to day operations and then charge the other parties, known as nonoperators, for their share of the operating costs. An operating agreement differs from a passive investment, such as a limited partnership, because the nonoperators have rights to influence the operations.<sup>99</sup> Operating agreements usually address in some fashion one or both of the following questions: (1) what property rights are affected by the agreement? and (2) what are the parties' rights and obligations with respect to the conduct of, and accounting for, drilling and production operations?

Most cases dealing with operating disputes are decided based upon the specific language of the agreement or the absence of any provision in the agreement. The language of the agreement is often more important than prior court decisions. Nevertheless, prior cases are indicative of how agreements will be interpreted, as well as judicial inclinations. Considering the dearth of Louisiana cases, common law authorities are often useful in determining how a court will interpret the agreement, and for discerning the custom of the industry.

### *B. Relationship of the Parties*

The characterization of the relationship between parties to an operating agreement often becomes the focus in determining the parties' rights and liabilities,<sup>100</sup> particularly when no provision of the agreement governs the matter in dispute. The concepts of joint venture, partnership and mandate, or agency, have been proffered as the proper characterization of the legal relationship normally created by joint oil and gas operating agreements.<sup>101</sup> The parties' rights and obligations, where not specified in the agreement, should be determined by equity, custom in the industry, and selective analogy to the law of co-ownership, partnership, and mandate.<sup>102</sup>

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99. See *Stewart v. Ragland*, 934 F.2d 1033 (9th Cir. 1991).

100. See *Sabine Supply Co. v. Cameron Oil Co.*, 175 La. 360, 143 So. 327 (1932).

101. See Howard L. Boigon, *The Joint Operating Agreement in a Hostile Environment*, 38 *Inst. on Oil & Gas L. & Tax'n* 5-1, 5-4 to 5-6 (1987); Christopher Lane & Catherine J. Boggs, *Duties of Operator or Manager to Its Joint Venturers*, 29 *Rocky Mtn. Min. L. Inst.* 199, 201-09 (1983); Ernest E. Smith, *Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners*, 32 *Rocky Mtn. Min. L. Inst.* 12-1, 12-5 to 12-12 (1986).

102. See La. Civ. Code art. 3; *id.* art. 2053; *Davis Oil Co. v. Steamboat Petroleum Corp.*, 583 So. 2d 1139 (La. 1991); *Sabine*, 175 La. 360, 143 So. 327; McCollam, *supra* note 59, at 75.

### 1. Joint Venture

Parties to an operating agreement often refer to co-participants as their partners even though partnership duties,<sup>103</sup> such as the fiduciary duty, may be inconsistent with their understanding of the agreement. A partnership or joint venture is an agreement between two or more persons to combine their property or labor for joint profit through joint control,<sup>104</sup> and is governed by the same rules as a partnership even when the parties may not have so intended.<sup>105</sup> A joint venture or partnership may be formed by an oral agreement or inferred from the conduct of the parties or other circumstances,<sup>106</sup> and its existence is a question of fact.<sup>107</sup> No satisfactory distinction between partnership and joint venture has been developed,<sup>108</sup> and one is probably unnecessary since the same

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103. The relationship of partnership or joint venture carries with it the following rights and liabilities:

- (1) Unless otherwise agreed, decisions affecting management must be made by majority vote, each partner having one vote, except that unanimity is required to amend the partnership agreement, admit new partners, terminate the relationship or permit a partner to withdraw without cause prior to the expiration of the term. La. Civ. Code art. 2807;
- (2) A partner owes a fiduciary duty to the partnership. Id. art. 2809;
- (3) A partner has the right to inform himself of the partnership's business and inspect its records. Id. art. 2813;
- (4) Each partner has the right to bind the partnership in the ordinary course of business, other than in the alienation, lease or encumbrance of immovable property. Id. art. 2814;
- (5) The partnership is principally liable for its debts, each partner is secondarily liable for his virile share of the debts; a provision that a partner is not so liable has no effect on third parties. Id. arts. 2817, 2815;
- (6) A partnership may expel a partner for just cause. Unless otherwise provided in the partnership agreement, the expulsion must be by majority vote. Id. art. 2820;
- (7) A partner may withdraw at any time not unfavorable to the partnership unless it has been constituted for a term, in which case the withdrawal must be based upon just cause arising out of the failure of another partner to perform an obligation. Id. arts. 2822, 2821; and
- (8) The partnership is a separate entity which may own assets, except that immovable property is owned by the partners unless the agreement is in writing. Id. art. 2806; *W. & W. Oil Co. v. American Supply Co.*, 8 So. 2d 384 (La. App. 2d Cir. 1942).

104. See *Riddle v. Simmons*, 589 So. 2d 89, 92 (La. App. 2d Cir. 1991), writ refused, 592 So. 2d 1316 (1992); *Esta v. Persohn*, 44 So. 2d 202 (La. App. Or. 1950).

105. La. Civ. Code art. 2801; *Grand Isle Campsites, Inc. v. Cheek*, 262 La. 5, 262 So. 2d 350 (1972).

106. *Riddle*, 589 So. 2d at 92.

107. *Prentice v. Amax Petroleum Corp.*, 187 So. 2d 752 (La. App. 1st Cir.), writ refused, 249 La. 617, 188 So. 2d 607 (1966).

108. See Blake West, Comment, *The Business Joint Venture in Louisiana*, 25 Tul. L. Rev. 382, 383 (1951).

rules govern both. It has, nevertheless, been suggested that a joint venture relates to a single enterprise, whereas a partnership relates to general business of a particular kind.<sup>109</sup>

Many operating agreements negate the existence of a partnership. Louisiana courts have held that a provision in an operating agreement negating the existence of a partnership will be given effect.<sup>110</sup> Furthermore, in 1980, the Louisiana Legislature enacted Mineral Code article 215, effective January 1, 1981, which provides that a written operating agreement will not create a partnership unless it expressly so provides.<sup>111</sup> Where the agreement is not written, or came into existence prior to 1981, the parties thereto may be joint venturers governed by the law of partnership. However, even if there is no partnership, a fiduciary duty may still exist if the relationship can be characterized as one of mandate.<sup>112</sup>

## 2. *Mandate*

The concept of mandate, or agency, has been used to impose liability upon nonoperators for obligations to third parties incurred by the operator.<sup>113</sup> A mandate is an act by which one person gives another the power to transact for him and in his name one or several affairs and may be for the joint interest of both parties.<sup>114</sup> This relationship may be created either expressly or by implication.<sup>115</sup>

The essential element of the relationship is that the principal has the right to control the conduct of the agent.<sup>116</sup> This element may be lacking in some areas, such as nonconsent operations, where the operator may pursue its own self interest even though that interest is opposite the interests of a nonoperator. However, this right to control may be present in other areas, such as the handling of lawsuits, where, depending upon the terms of the agreement, the nonoperator may have effective control over the operator's conduct.

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109. *Id.* at 386; *Riddle*, 589 So. 2d at 92.

110. See *Sabine Supply Co. v. Cameron Oil Co.*, 175 La. 360, 143 So. 327 (1932); *Prentice v. Amax Petroleum Corp.*, 220 So. 2d 783 (La. App. 1st Cir.), writ denied, 254 La. 455, 223 So. 2d 867 (1969).

111. La. R.S. 31:215 (1989).

112. See *Britton v. Green*, 325 F.2d 377 (10th Cir. 1963); cf. *McCollam*, *supra* note 59, at 71-81 (rules of mandate may apply to unit operator).

113. See *infra* text accompanying note 206.

114. La. Civ. Code arts. 2985, 2986.

115. *Craft v. Trahan*, 351 So. 2d 277 (La. App. 3d Cir. 1977), writ refused, 353 So. 2d 1336 (1978).

116. *Id.* at 281.

### 3. *The Fiduciary Duty*

A partner or a mandatary owes a fiduciary duty to the principal.<sup>117</sup> The fiduciary duty establishes a standard of conduct that has been summarized as follows:

[The fiduciary relationship] imposes upon [fiduciaries] the obligation of the utmost good faith and fairness in their dealings with one another with respect to partnership affairs. Each partner must refrain from taking any advantage of another partner by the slightest misrepresentation or concealment of material facts. The obligation is especially stringent on a partner who is managing the business, his duty being analogous to that of a trustee.<sup>118</sup>

As may be inferred from the foregoing, the fiduciary duty carries with it an obligation to disclose material information and to refrain from acquiring any secret advantage or profit in connection with the enterprise.<sup>119</sup>

However, many customs of the oil and gas industry conflict with the requirements of a fiduciary duty. For example, the custom of the oil and gas industry treats certain information, particularly geological interpretations, as proprietary and not to be shared, even with co-participants.<sup>120</sup> In Louisiana, the fiduciary duty may be eliminated by provisions that reflect the parties' intent to preclude such a relationship of trust, such as a provision that negates the existence of a partnership<sup>121</sup> or one that contains contractual provisions contrary to such a duty.<sup>122</sup> Even the common law courts that have been willing to find the existence of a joint venture, or mining partnership, in spite of such provisions,<sup>123</sup> have generally imposed a fiduciary duty only in nonoperational spheres

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117. *Noe v. Roussel*, 310 So. 2d 806 (La. 1975). Indeed, partnership is a type of mandate. Cf. La. Civ. Code art. 2814 (partner is mandatary for partnership).

118. *W.A. McMichael Constr. Co. v. D & W Properties, Inc.*, 356 So. 2d 1115, 1122 (La. App. 2d Cir.), writ denied, 359 So. 2d 198 (1978).

119. *Grand Isle Campsites, Inc. v. Cheek*, 262 La. 5, 262 So. 2d 350 (1972); *Prentice v. Amax Petroleum Corp.*, 187 So. 2d 752 (La. App. 1st Cir.), writ refused, 249 La. 617, 188 So. 2d 607 (1966).

120. See *Tenneco Oil Co. v. Bogert*, 630 F. Supp. 961 (W.D. Okla. 1986) (held that under Oklahoma law no fiduciary duty exists to share information regarding production outside of contract area).

121. *Prentice v. Amax Petroleum Corp.*, 220 So.2d 783 (La. App. 1st Cir.), writ denied, 254 La. 455, 223 So. 2d 867 (1969).

122. *Caddo Oil Co., Inc. v. O'Brien*, 908 F.2d 13 (5th Cir. 1990) (no fiduciary duty to provide accounting of expenditures).

123. E.g., *Great W. Oil & Gas Co. v. Mitchell*, 326 P.2d 794 (Okla. 1958); *Stephens v. Allen*, 237 S.W.2d 72, 74 (Ky. App. 1951).

such as marketing production<sup>124</sup> or accounting for production revenues.<sup>125</sup> In the absence of a statutory or contractual negation, some kind of trust relationship may be appropriate in nonoperational spheres since the nonoperator has literally entrusted his own property or money to the operator, not just property in which they both have an interest. Some commentators and common law courts have focused upon the sophistication of the participants in deciding whether to impose a fiduciary duty upon the operator.<sup>126</sup> This type of factual inquiry may seem equitable but should be rejected because it causes far too much uncertainty regarding the operator's duties. In any event, the parties to an operating agreement are required to perform the obligations in good faith.<sup>127</sup>

#### 4. *Third Parties*

In the absence of a stipulation *pour autrui*, the rights and obligations created by an operating agreement should extend only to the parties thereto. However, in *Huggs, Inc. v. LPC Energy, Inc.*,<sup>128</sup> the court held that an operator, who acquired its interest in a mineral lease subject to an overriding royalty, was liable in damages to the owner of the overriding royalty even though the latter was not a party to the operating agreement. The court rejected the operator's lack of privity argument and, employing a tort analysis, held that the operator's duty under the operating agreement to maintain the lease extended to the overriding royalty owner because such owner was at risk should the lease be negligently lost. The court's reasoning is flawed, however, because, without agreement, the operator had no duty to maintain the lease, and the operator agreed only to protect the nonoperators' interest, not that of third parties.<sup>129</sup> The notion that the duties imposed in an operating agreement can extend to nonparties is a considerable expansion of the law that could create numerous unforeseen liabilities. Therefore, *Huggs* should be overruled or limited to its facts.

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124. See *Howell v. Bach*, 580 S.W.2d 711 (Ky. App. 1978); but see *Gerard J. W. Bos & Co., Inc. v. Harkins & Co.*, 883 F.2d 379 (5th Cir. 1989).

125. See *Reserve Oil, Inc. v. Dixon*, 711 F.2d 951 (10th Cir. 1983); but see *In re Wilson*, 69 B.R. 960 (Bankr. N.D. Tex. 1987).

126. See *Smith*, *supra* note 101, at 12-1; *Dime Box Petroleum Corp. v. Louisiana Land & Exploration Co.*, 717 F. Supp. 717 (D. Colo. 1989).

127. La. Civ. Code art. 1983.

128. 889 F.2d 649 (5th Cir. 1989).

129. See *Avatar Exploration, Inc. v. Chevron, U.S.A., Inc.*, 933 F.2d 314 (5th Cir. 1991) (overriding royalty owners have no standing to seek damages for breach of agreement).

### C. The Effect on Title

#### 1. Writing Requirement

The parol evidence rule conclusively prohibits proof of ownership of immovable property by testimony,<sup>130</sup> except where the vendor admits the sale under oath at trial and the item has been delivered.<sup>131</sup> Therefore, an operating agreement must be in writing to affect title to a real right such as land, a mineral servitude, or a mineral lease.<sup>132</sup> The writing must clearly declare the parties' intent to be bound and the basic terms of the agreement,<sup>133</sup> but the writing need not be in a particular form.<sup>134</sup> For example, in *Chevron U.S.A., Inc. v. Martin Exploration Co.*,<sup>135</sup> the court held that an exchange of telexes constituted a writing sufficient to establish a lease forfeiture penalty for failure to participate in operations.

What constitutes an effect upon title to a real right is not always readily apparent. In *Hayes v. Muller*,<sup>136</sup> the court rejected the plaintiff's claim that it was entitled to a share of the consideration defendant received for the sale of a mineral lease. The plaintiff argued that parol evidence was admissible to establish that the lease was owned by a joint venture between plaintiff and defendant with title nominally held in defendant's name. The court rejected the argument that the claim was for an accounting and had no effect on title on the grounds that the claim necessarily depended upon oral proof that the mineral lease was owned by the joint venture.<sup>137</sup>

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130. *Little v. Haik*, 246 La. 121, 163 So. 2d 558 (1964).

131. See La. Civ. Code art. 1839 (verbal sale); *Larido v. Perkins*, 132 La. 660, 61 So. 728 (1913).

132. La. R.S. 31:16, 31:18 (1989); see *Hayes v. Muller*, 245 La. 356, 158 So. 2d 191 (1963).

133. See *Chauvin v. Bohn*, 411 So. 2d 442 (La. 1982); *Jackson v. Dominick*, 166 So. 867 (La. App. 2d Cir. 1936).

134. Cf. *Crescent Drilling & Dev., Inc. v. Sealexco, Inc.*, 570 So. 2d 151 (La. App. 3d Cir. 1990) (title proved not by assignment but by written extrinsic evidence and parol evidence), writ denied, 575 So. 2d 373 (1991).

135. 447 So. 2d 469 (La. 1984).

136. 245 La. 356, 158 So. 2d 191 (1963).

137. In *Grand Isle Campsites, Inc. v. Cheek*, 262 La. 5, 262 So. 2d 350 (1972), the court relied upon parol evidence to establish the existence of a joint venture between plaintiff and defendant to acquire real estate, holding the defendant liable in the amount of a secret profit made on a sale to the joint venture for breach of his fiduciary duty. *Hayes* and *Cheek* are distinguishable because in *Cheek* the award was based upon a breach of fiduciary duty while in *Hayes* the relief sought depended upon ownership of the property in question. Presumably, if the defendant in *Cheek* had sold the property to a third party, instead of the joint venture, he would have incurred no liability. Additionally, parol evidence is admissible to prove a joint venture to share profits from co-owned immovable property. *Riddle v. Simmons*, 589 So. 2d 89 (La. App. 2d Cir. 1991), writ refused, 592 So. 2d 1316 (1992).



## 2. Public Records

All contracts affecting a mineral right must be recorded in the public records to have effect on third parties.<sup>138</sup> The mere reference to an operating agreement in a recorded instrument does not have any effect on third parties.<sup>139</sup> Assignees and mortgagees of a party to an unrecorded operating agreement will not themselves be bound by it absent express agreement.<sup>140</sup> However, a party who acquires a mineral lease by an assignment which provides that it is made subject to an unrecorded operating agreement will be bound by the referenced agreement.<sup>141</sup> In *Transworld Drilling Co. v. Texas General Petroleum Co.*,<sup>142</sup> the court held that whether an assignee assumes the assignor's liabilities under an operating agreement when the assignee takes an assignment subject to the operating agreement is a question of fact depending upon the parties' intent.<sup>143</sup> Furthermore, a mortgagee who obtains a pledge of production proceeds subject to an unrecorded agreement is liable for the mortgagor's share of the well costs to the extent of the revenue received by the mortgagee.<sup>144</sup>

Parties to operating agreements are reluctant to record them because recordation often reveals their plans to explore for and produce oil and gas, as well as their rights and obligations. In Louisiana, a declaration in lieu of the agreement may be filed in the public records in order to put third parties on notice of the existence of an agreement.<sup>145</sup> Such a declaration must: (a) be signed by a party designated as operator or agent; (b) contain a description of the property covered by the agreement; (c) state the general nature or import of the agreement; and (d) designate the location where a complete copy of the agreement may be found. However, such a declaration may give the public the right to review the operating agreement, and no court has decided to what extent the declaration binds third parties insofar as provisions not referred to in the declaration are contained in the operating agreement.

## 3. The Term

An operating agreement must have a certain and definite term, or it will be terminable at will unless a term may be implied commensurate

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138. La. R.S. 9:2731 (1991).

139. See *Sklar Producing Co. v. Rushing*, 262 So. 2d 115 (La. App. 2d Cir.), writ denied, 262 La. 310, 263 So. 2d 47 (1972).

140. See *Grace-Cajun Oil Co. No. 3 v. FDIC*, 882 F.2d 1008 (5th Cir. 1989).

141. See *Gulf Oil Corp. v. Adams*, 209 So. 2d 770 (La. App. 2d Cir.), writ denied, 252 La. 473, 211 So. 2d 333 (1968).

142. 524 So. 2d 215 (La. App. 4th Cir. 1988).

143. But see *Grace-Cajun Oil Co. No. 3 v. FDIC*, 882 F.2d 1008 (5th Cir. 1989) (one who acquires "subject to" incurs no personal liability).

144. *Id.*

145. La. R.S. 9:2732 (1991).

with the nature of the contemplated operations.<sup>146</sup> However, an operating agreement will only preclude a partition between co-owners if the parties specifically agree to a term in writing.<sup>147</sup> Further, to the extent that title to real property is affected, any agreement regarding the term must be in writing to be binding upon the parties and recorded to be binding upon third parties.

What constitutes a certain and definite term is a question of degree. In *Giardina v. Giardina*,<sup>148</sup> the court held that an agreement not to partition property until there was a favorable real estate market when a fair and reasonable price could be obtained was too uncertain and indefinite to be enforceable. On the other hand, in *Eads Operating Co., Inc. v. Thompson*,<sup>149</sup> the court held that a provision stating that the operating agreement would remain in effect as long as oil or gas is, *or can be*, produced in paying quantities from a certain geological formation, or sand, necessitated a factual hearing regarding the productive capacity of the formation, despite evidence that there had been no production for over two years and that the mineral leases had been abandoned. While defining the term to be as long as production is *actually* obtained in paying quantities is satisfactory,<sup>150</sup> a term based upon the productive *capability* of a sand seems uncertain and indefinite given the imprecise nature of geology and reservoir engineering.

#### 4. Share of Production

The execution of an agreement containing cost and profit sharing provisions does not ordinarily constitute an assignment of real rights.<sup>151</sup> Nonetheless, in *Crow Drilling & Producing Co. v. Hunt*,<sup>152</sup> the parties executed a letter agreement specifying their respective shares of the costs and revenues of wells on the same day that an operating agreement was executed. The court held that, in view of the separate letter agreement, the failure of one party's title to mineral leases did not diminish his share of production even though the operating agreement provided for reducing his interest in the event of title loss.

A number of cases have held that an agreement between lease owners fixing the distribution of production from wells is not altered or ab-

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146. See La. Civ. Code art. 2054.

147. See *Delta Drilling Co. v. Oil Fin. Corp.*, 195 La. 407, 196 So. 914 (1940).

148. 181 La. 42, 158 So. 615 (1935).

149. 537 So. 2d 1187, 1194 (La. App. 1st Cir. 1988), writ denied, 538 So. 2d 614 (1989).

150. See *Producers Oil Co. v. Gore*, 610 P.2d 772 (Okla. 1980) (term equal to life of mineral lease not violative of rule against perpetuities).

151. See Perry Pearce, *The Legal Relationships Among Parties to a Unit*, 34th Ann. Inst. on Min. L. 107, 114 (1987).

152. 254 La. 662, 226 So. 2d 487 (1969).

rogated by the creation of a commissioner's unit.<sup>153</sup> However, in *Kaiser Aluminum Exploration Co. v. Celeron Oil & Gas Co.*,<sup>154</sup> the court held that whether an agreement fixing the parties' share of costs and revenues was altered by a commissioner's unit raised a question of fact regarding the parties' intent.

### 5. Gas Balancing

As previously discussed, a party who has taken less than its share of gas may make up the difference, or balance, by taking more than its share of gas until its takes have become ratable with the other party.<sup>155</sup> Where this in-kind method of balancing will not permit the underproduced party to recover his just or equitable share, then that party may make up by cash balancing, i.e., requiring the overproduced party to pay him for his share of the gas that he did not receive.<sup>156</sup> In *Pogo Producing Co. v. Shell Offshore, Inc.*,<sup>157</sup> the court rejected a claim for cash balancing where the operating agreement did not provide for balancing and the well had not depleted. In *Chevron U.S.A., Inc. v. Belco Petroleum Corp.*,<sup>158</sup> the court rejected Chevron's claim for cash balancing after the well had depleted because the balancing agreement, which Chevron proposed, provided only for in kind balancing. At a minimum, *Belco* establishes that where the parties have agreed there will be no cash balancing, that agreement will be given effect even if it deprives a party of its pro rata share of the gas. However, a fair interpretation of *Belco* is that a failure to mention cash balancing in a balancing agreement will preclude that remedy even if the well depletes.

### 6. Acquisitions of Additional Acreage

In the absence of a fiduciary duty, the parties are free to acquire acreage without disclosing the acquisition to, or sharing it with, the other parties to the agreement.<sup>159</sup> Area of mutual interest and acreage

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153. *Id.*; see *Monsanto Chem. Co. v. Southern Natural Gas Co.*, 234 La. 939, 102 So. 2d 223 (1958); *Southwest Gas Producing Co. v. Creslenn Oil Co.*, 181 So. 2d 63 (La. App. 2d Cir. 1965), writ denied, 248 La. 797, 182 So. 2d 74 (1966).

154. 526 So. 2d 374 (La. App. 4th Cir.), writ denied, 531 So. 2d 278 (1988).

155. See *supra* text accompanying notes 96-98. *Pogo Prod. Co. v. Shell Offshore, Inc.*, 898 F.2d 1064 (5th Cir. 1990). For a thorough discussion of gas balancing see Patrick Martin, *The Gas Balancing Agreement: What, When, Why and How*, 36 Rocky Mtn. Min. L. Inst. 13-1 (1990).

156. See *Pogo*, 898 F.2d 1064.

157. *Id.*

158. 755 F.2d 1151 (5th Cir.), cert. denied, 474 U.S. 847, 106 S. Ct. 140 (1985).

159. Compare *Prentice v. Amax Petroleum Corp.*, 220 So. 2d 783 (La. App. 1st Cir.), writ denied, 254 La. 455, 223 So. 2d 867 (1969) with *Palmer v. Fuqua*, 641 F.2d 1146 (5th Cir. 1981); *Kaye v. Smitherman*, 225 F.2d 583 (10th Cir. 1955).

or cash contribution provisions are often used to ensure that the parties share in acquisitions related to the contract area where there is no fiduciary duty.

An area of mutual interest provision provides that any party who acquires a mineral interest in a certain area must offer it to the other parties on a pro rata basis.<sup>160</sup> An acreage or cash contribution clause provides that a party receiving a contribution of cash, or acreage lying outside of the contract area, toward the drilling of a well on the contract area must share it with the other parties.<sup>161</sup> The area of mutual interest clause serves to maintain the parties' participation percentages in an area; the acreage contribution clause serves to maintain those percentages with respect to individual wells.

*a. Area of Mutual Interest*

The area of mutual interest provision typically covers any acquisition of mineral rights, whether by purchase, farmout,<sup>162</sup> or contribution. So long as the acreage falls within the area of mutual interest, it must be offered to the other parties. Litigation over these provisions has focused on how the nonacquiring party elects to participate in the acquisition.

In *Lyle Cashon Co. v. McKendrick*,<sup>163</sup> the court held that while the defendant had not explicitly exercised his option to participate in the plaintiffs' acquisition of a lease in an area of mutual interest, his intent to exercise that option was evidenced by the parties' actions. The court further noted that the plaintiff was estopped to deny defendant's interest because plaintiff had accepted the benefits of defendant's activities in furtherance of the development of the acreage. However, in *J-O'B Operating Co. v. Newmont Oil Co.*,<sup>164</sup> the court held that the plaintiff had not properly exercised its option to participate in the acquisition because, although it notified defendant of its intent to participate, it refused to pay certain costs which it contended were not necessary for the acquisition. The court concluded that the area of mutual interest provision did not allow the electing party to contest the necessity for, or the extent of, any consideration paid by the acquirer for the interest.

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160. See *J-O'B Operating Co. v. Newmont Oil Co.*, 560 So. 2d 852 (La. App. 3d Cir.), writ denied, 565 So. 2d 449 (1990).

161. See *Superior Oil Co. v. Cox*, 307 So. 2d 350 (La. 1975).

162. A farmout is an agreement to assign a mineral interest, usually a lease, conditioned upon the drilling of a well. *Robinson v. North Am. Royalties*, 509 So. 2d 679 (La. App. 3d Cir. 1987).

163. 204 F.2d 609 (5th Cir. 1953).

164. *J-O'B*, 560 So. 2d 852.

*b. Acreage Contribution*

Historically, a contribution was regarded as a conveyance of cash or mineral rights by one party to another party to induce the latter to drill a well. It has been suggested, however, that the word "contribution" refers to the fact that the acreage will be included in, and, therefore, "contribute" to, a unit for the well in question. In *Superior Oil Co. v. Cox*,<sup>165</sup> the operator acquired a farmout of acreage outside the contract area from another party to the operating agreement. The farmout agreement provided that if the operator drilled a well, he would receive an assignment of that portion of the farmout acreage included in a unit for the well. The plaintiff, also a party to the operating agreement, claimed that since the earning well was located on the contract area, and the farmout acreage was subsequently included in the unit for said well, the contribution clause obligated the operator to offer the farmout acreage to plaintiff because it "contributed to" the well. The Louisiana Supreme Court rejected this claim, stating that the acreage earned under the farmout agreement was not a contribution because it was not earned solely by the drilling of a well; the acreage earned also depended upon the Commissioner of Conservation's subsequent determination that the acreage should be included in the unit. The court also explained that the contribution clause only applied to acreage obtained from persons who were not parties to the operating agreement. Interestingly, in *Harper Oil Co. v. Yates Petroleum Corp.*,<sup>166</sup> the New Mexico Supreme Court relied upon *Superior* to hold that the acreage contribution clause did not apply to assignments or contributions between parties to the operating agreement. The *Harper* court held that a nonoperator's farmout to the operator in order to avoid a nonconsent penalty did not constitute an acreage contribution.

*7. Preferential Rights to Purchase*

A preferential right to purchase mineral leases obligates a party desiring to sell to offer an assignment of the lease to the other participants prior to assigning or releasing it.<sup>167</sup> These rights must be promptly asserted, or they will be waived. In *Marken v. Goodall*,<sup>168</sup> the court held that the plaintiff waived his right to enforce a preferential right to purchase by failing to assert it timely while the defendants engaged

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165. 307 So. 2d 350 (La. 1975).

166. 733 P.2d 1313 (1987).

167. It should be noted, however, that a party who assigns a lease pursuant to a preferential purchase obligation in an operating agreement will not be released of liability to the lessor. La. R.S. 31:129 (1989).

168. 478 F.2d 1052 (10th Cir. 1973).

in costly operations. In contrast, however, the court in *Mobil Exploration & Producing North America, Inc. v. Graham Royalty, Ltd.*,<sup>169</sup> applied Arkansas law to hold that the plaintiff had not unduly delayed exercising its preferential right even though it was not asserted within the contractual time period, because defendant had not given proper notice and could not establish any detrimental reliance.

#### *D. Operational Rights and Liabilities*

##### *1. Removal of the Operator*

No Louisiana cases address under what circumstances an operator may be removed. The notion that the operator may be terminated by majority vote<sup>170</sup> gives insufficient weight to the parties' prior agreement appointing the operator. Absent a contrary agreement, the operator should have the same right to maintain his office as a mandatary with an interest in the subject property of the mandate, i.e., the operator should be removable only for cause.<sup>171</sup> Likewise, the operator should be able to resign at any time so long as the nonoperators are not prejudiced by the timing of the resignation.<sup>172</sup>

##### *2. Lease Maintenance*

Absent a contrary agreement, each party is responsible for the payment of rentals and royalties necessary for the maintenance of its own mineral rights.<sup>173</sup> The operator may be liable to the nonoperator where mineral rights are lost as a result of the operator's failure to exercise due care in maintaining production or operations.<sup>174</sup> However, an operator will not be liable for loss of mineral rights where the nonoperator's failure to pay its share of the costs prevents the operator

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169. 910 F.2d 504 (8th Cir. 1990).

170. Cf. La. Civ. Code art. 2807 (decisions affecting partnership made by majority vote).

171. See *Robinson v. Hunt*, 211 La. 1019, 31 So. 2d 197 (1946); *Montgomery v. Foreman*, 410 So. 2d 1160 (La. App. 3d Cir. 1982). See also *Envirogas Inc. v. Walker Energy Partners*, 641 F. Supp. 1339 (W.D.N.Y. 1986). See also Marcel Planiol, *Civil Law Treatise*, Vol. 2, pt. 2, 171 (LSU 1959) (appointed managers cannot be removed except for legitimate cause, such as breach of trust or incapacity).

172. See *Lancaster v. Petroleum Corp. of Del.*, 491 So. 2d 768 (La. App. 3d Cir. 1986) (operator breached agreement by resigning without giving required 90-day notice).

173. See *supra* text accompanying note 129.

174. *Huggs Inc. v. LPC Energy, Inc.*, 889 F.2d 649 (5th Cir. 1989). See *Estis v. Monte Carlo Exploration, Inc.*, 558 So. 2d 341 (La. App. 3d Cir.), writ denied, 563 So. 2d 879 (1990) (in action by nonoperator involving loss of lease, operator's conduct measured by due diligence standard).

from conducting the operations necessary to maintain those rights.<sup>175</sup>

### 3. *Nonconsent Operations*

The general rule in Louisiana is that, absent an agreement, no operations can be conducted upon a co-owned lease without the unanimous consent of all of the co-owners.<sup>176</sup> Most operating agreements eliminate this potential obstacle to development by providing that under certain circumstances a party may conduct mineral operations even though some or all of the remaining co-owners do not consent to the operations.

Most oil companies would be unwilling to drill a well if a non-consenting party, who assumed none of the financial burden or risks associated with drilling, could share in the proceeds of production as soon as its share of costs had been recouped out of production. Thus, most joint operating agreements provide that the nonconsenting party will forfeit his right to share in some or all of the production from the well even after the costs have been recouped. Such a provision is known as a risk charge or nonconsent penalty.<sup>177</sup>

In *Chevron U.S.A., Inc. v. Martin Exploration Co.*,<sup>178</sup> the Louisiana Supreme Court enforced a provision in an operating agreement that required a party who did not participate in the drilling of wells to forfeit his entire interest in the lease. However, acceptance of well cost payments from a nonoperator that has not timely elected to participate in a well can result in waiver of the forfeiture.<sup>179</sup>

### 4. *Sharing Costs*

#### a. *Form of Agreement*

Probably the simplest form of operating agreement is the agreement to share the costs of drilling and operating a well.<sup>180</sup> Although some common law cases suggest that the nonoperators' agreement to share in the costs must be in writing,<sup>181</sup> in Louisiana such an agreement may

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175. *Estis*, 558 So. 2d 341.

176. See *supra* text accompanying note 41.

177. See *General Am. Oil Co. of Tex. v. Superior Oil Co.*, 416 So. 2d 251, 257 n.6 (La. App. 3d Cir.), writ denied, 421 So. 2d 908 (1982).

178. 447 So. 2d 469 (La. 1984).

179. See *Crescent Drilling & Dev., Inc. v. Sealexco, Inc.*, 570 So. 2d 151 (La. App. 3d Cir. 1990), writ denied 575 So. 2d 573 (1991).

180. See *Sterling v. McKendrick*, 134 So. 2d 655, 658 (La. App. 4th Cir. 1961).

181. See *Sonat Exploration Co. v. Mann*, 785 F.2d 1232, 1234 n.1 (5th Cir. 1986); see also *Huffco Petroleum Corp. v. Massey*, 834 F.2d 540 (5th Cir. 1987) (under Mississippi law, in the absence of a written operating agreement, a statement that "payment will be forthcoming" was too ambiguous).

be oral or implied from the parties' conduct.<sup>182</sup> In *Connette v. Wright*,<sup>183</sup> the Louisiana Supreme Court implied a promise to pay, despite an explicit refusal to participate, based upon a co-owner's acceptance of production and opposition to a partition.<sup>184</sup> While the court's reasoning in implying consent in the face of an explicit refusal to participate is suspect, the result reflects a frequently encountered judicial reluctance in Louisiana to permit one party to benefit from another party's efforts.

*b. Waiver, Ratification and Estoppel*

The doctrines of waiver, ratification and estoppel are often employed to the same end. In *Exchange Oil & Gas Corp. v. Great American Exploration Corp.*,<sup>185</sup> the court, without citing *Connette*, correctly ruled that under Louisiana law the agreement to pay need not be in writing and applied the doctrine of equitable estoppel to hold a nonoperator liable for drilling costs upon a showing that the operator relied to his detriment upon the nonoperator's representation that it would pay its share of drilling costs.<sup>186</sup> The court found that the operator's detriment was that "it lost the opportunity to gain control of the entire working interest" and that the nonoperator had the opportunity "to wait until the drilling was completed and with geological hindsight decide whether it wished to risk any venture capital."<sup>187</sup> Some common law cases have rejected claims of detrimental reliance under similar circumstances.<sup>188</sup>

*c. AFE's*

Oil and gas operating companies often circulate authorizations for expenditure ("AFE") to advise potential participants of the nature of the operations and their estimated cost. Many AFE's contain a signature space preceded by the words: "agreed to and accepted." While no Louisiana case has addressed the effect of the execution of an AFE,

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182. See *Caddo Oil Co., Inc. v. O'Brien*, 908 F.2d 13 (5th Cir. 1990) (consent not implied); *Connette v. Wright*, 154 La. 1081, 98 So. 674 (1924) (consent implied); *Hobbs v. Central Equip. Rentals, Inc.*, 382 So. 2d 238 (La. App. 3d Cir.), writ refused, 385 So. 2d 785 (1980) (verbal); *Sterling v. McKendrick*, 134 So. 2d 655 (La. App. 4th Cir. 1961) (testimony and correspondence); cf. *Riddle v. Simmons*, 589 So. 2d 89, 93 (La. App. 2d Cir. 1991), writ refused, 592 So. 2d 1316 (1992) (parol evidence admissible to establish profit sharing of co-owned property).

183. 154 La. 1081, 98 So. 674 (1924).

184. Compare *Caddo*, 908 F.2d 13 (on similar facts, no implied consent).

185. 789 F.2d 1161 (5th Cir. 1986).

186. The opinion gives no reason why the court relied upon equitable estoppel instead of oral or implied consent.

187. *Exchange Oil*, 789 F.2d at 1164.

188. See *Huffco Petroleum Corp. v. Massey*, 834 F.2d 540 (5th Cir. 1987); *Sonat Exploration Co. v. Mann*, 785 F.2d 1232 (5th Cir. 1986).



other jurisdictions have held that it is a question of fact whether, in the absence of a written operating agreement, the execution of an AFE alone constitutes an agreement by the nonoperator to share costs.<sup>189</sup>

### 5. *Scope of the Operations*

Consent to an operation includes consent to all necessary expenditures; absent a contrary intent, the estimate of the costs in an AFE is not a limit on expenditures.<sup>190</sup> What constitutes a necessary expenditure is a question of fact depending upon the intention of the parties as reflected in their words and deeds and the custom of the industry.<sup>191</sup> For instance, in *Holt Oil & Gas Corp. v. Harvey*,<sup>192</sup> the court held that under Texas law it was a question of fact as to whether sidetracking operations required the approval of the nonoperators, or whether the initial consent to drill the well included consent to such operations. Where the operator deviates in a material way from the procedure set forth in the AFE, courts have limited the nonoperator's liability because the nonoperator consents to the AFE procedure and not the material deviation. Thus, Texas courts have relieved nonoperators from liability for the costs of a well drilled at a location different from that specified in the AFE,<sup>193</sup> or for the added costs of a well drilled on a day rate basis as opposed to the footage basis specified in the AFE.<sup>194</sup>

### 6. *Operator's Standard of Conduct*

#### a. *In General*

In the actual conduct of drilling and production operations, the operator is not governed by a fiduciary duty even in those common law jurisdictions willing to find a joint venture in the face of a disclaimer.<sup>195</sup> This is due in part to the speculative and risky nature of

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189. Compare *Sonat*, 785 F.2d 1232 (under Mississippi law, no agreement) with *G.H.K. Co. v. Jones Invs., Inc.*, 748 P.2d 45 (Okla. App. Div. 3 1987) (agreement).

190. Compare *M&T, Inc. v. Fuel Resources Dev. Co.*, 518 F. Supp. 285 (D. Colo. 1981) (nonoperator's liability not limited by AFE) with *Forest Oil Corp. v. Superior Oil Co.*, 338 So. 2d 758 (La. App. 4th Cir. 1976) (language of operating agreement allowed operator to overrun initial AFE by only fifty percent).

191. See La. Civ. Code art. 2053.

192. 801 F.2d 773 (5th Cir. 1986), cert. denied, 481 U.S. 1015, 107 S. Ct. 1892 (1987).

193. *Hamilton v. Texas Oil & Gas Corp.*, 648 S.W.2d 316 (Tex. Civ. App. El Paso 1982, writ ref'd n.r.e.).

194. *Haas v. Gulf Coast Natural Gas Co.*, 484 S.W.2d 127 (Tex. Civ. App. Corpus Christi 1972).

195. See, e.g., *Frankfort Oil Co. v. Snakard*, 279 F.2d 436 (10th Cir.), cert. denied, 364 U.S. 920, 81 S. Ct. 783 (1960).

such operations and the fact that the operator ordinarily will share in any losses occasioned by his bad judgment or honest error.<sup>196</sup> In *Sterling v. McKendrick*,<sup>197</sup> the Louisiana Fourth Circuit Court of Appeal stated in dicta that each participant is liable for his pro rata share unless the operator is guilty of negligence in the execution of his delegated authority.<sup>198</sup> However, such a simple standard imposes too much responsibility upon the operator by failing to consider the nonoperator's assumption of risks inherent in drilling operations. In *J.E. Crosbie, Inc. v. King*,<sup>199</sup> the Oklahoma Supreme Court succinctly set forth an appropriate standard of care, in the absence of a contrary agreement, governing the operator's conduct of operations:

All of the authorities are agreed that partners assume the risk of loss that comes from bad judgment. . . . All that is required of a managing partner is good faith . . . and reasonable skill and diligence. All partners share equally losses occasioned by the bad judgment of any one partner. A managing partner is not liable alone for a loss occasioned by honest error, or by bad judgment.<sup>200</sup>

Thus, the operator's standard of care should be reasonable skill and diligence. As long as the operator is not guilty of bad faith, fraud, or culpable negligence, the nonoperators must share in the losses resulting from the operator's bad judgment and good faith errors. However, the parties are free to contractually limit the operator's liability.

#### *b. Gross Negligence*

Many agreements provide that the operator shall conduct operations in a workmanlike fashion, but shall have no liability except for gross negligence.<sup>201</sup> Gross negligence has been defined as the entire absence of care, or utter disregard of the dictates of prudence, amounting to a complete neglect of the rights of others.<sup>202</sup> Article 3556(13) of the Louisiana Civil Code defines gross fault as inexcusable negligence or ignorance

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196. See Lane & Boggs, *supra* note 101, at 223-24.

197. 134 So. 2d 655 (La. App. 4th Cir. 1961).

198. *Id.* at 658.

199. 133 P.2d 543 (Okla. 1943).

200. *Id.* at 546 (citations omitted). See also *Arkla Exploration Co. v. Shadid*, 710 P.2d 126 (Okla. App. 1985).

201. E.g., *Lancaster v. Petroleum Corp. of Del.*, 491 So. 2d 768 (La. App. 3d Cir. 1986). See also *Oryx Energy Co. v. Tatex Energy*, 779 F. Supp. 144 (D. Colo. 1991) (operator only liable for operations conducted in bad faith).

202. *Hendry Corp. v. Aircraft Rescue Vessels*, 113 F. Supp. 198, 201 (E.D. La. 1953) (citing *Hollander v. Davis*, 120 F.2d 131 (5th Cir. 1941)). See also *State v. Vinzant*, 200 La. 301, 315, 7 So. 2d 917, 922 (1942) (absence of even slight care and diligence).

that is nearly equal to fraud.<sup>203</sup> There seems to be little difference between gross negligence and recklessness. However, ordinary negligence in attending to a critical task has been characterized as gross negligence.<sup>204</sup>

### 7. *Liability to Third Parties*

In the absence of a pure agency relationship, the operator will be liable for the debts it incurs. The liability of nonoperators to third parties for debts incurred by the operator in the conduct of the operations will depend upon whether the operating agreement negates the existence of an agency relationship or partnership. In *Sabine Supply Co. v. Cameron Oil Co.*,<sup>205</sup> the Louisiana Supreme Court held that the nonoperator was not liable for debts contracted by the operator, where the agreement provided that the operator was not an agent and had no authority to act for the nonoperator and that any expenses incurred in the management and supervision of operations would be the operator's sole responsibility unless the nonoperator consented to same in writing. In the absence of such a disclaimer, nonoperators were held liable to third parties on the basis of partnership law with each partner responsible for his virile share of the partnership debts, irrespective of his percentage share of the partnership.<sup>206</sup> However, no case has yet addressed the impact of Mineral Code article 215 on the liability of nonoperators to third parties in privity with the operator. Undoubtedly, the issue will turn upon whether the courts apply the law of mandate in spite of article 215's negation of a partnership.<sup>207</sup>

### E. *Accounting, Collections and Litigation*

#### 1. *The Operator's Duty to Account for the Nonoperator's Funds*

The operator, by undertaking to manage the affairs of another,<sup>208</sup> probably incurs the mandatary's obligation to render an

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203. La. Civ. Code art. 3556(13) (1953, redesignated 3506(13) (1991)).

204. See *Huggs, Inc. v. LPC Energy, Inc.*, 889 F.2d 649 (5th Cir. 1989). See also *Grace-Cajun Oil Co. No. Two v. Damson Oil Corp.*, 897 F.2d 1364 (5th Cir. 1990) (trial court found gross negligence in operator's failure to file for higher priced gas).

205. 175 La. 360, 143 So. 327 (1932).

206. *Duncan v. Gill*, 227 So. 2d 376 (La. App. 4th Cir. 1969), writ denied, 255 La. 338, 230 So. 2d 834 (1970) (nonoperator is liable for virile share); *Young v. Reed*, 192 So. 780 (La. App. 2d Cir. 1939) (nonoperator liable for virile share of contract debts regardless of percentage interest in venture); *Langston v. Red Iron Drilling Co.*, 38 F. Supp. 136 (W.D. La. 1941) (nonoperator liable for virile share of personal injuries).

207. See *Boigon*, supra note 101, at 5-5 (disclaimer of partnership inconsistent with intent to create agency). Cf. *Davidson v. Enstar Corp.*, 860 F.2d 167 (5th Cir. 1988) (disregarding language of operating agreement to find existence of joint venture preventing tort liability for nonoperator). Persons who knowingly deal with agents are under an obligation to inquire as to the extent of an agent's authority and are charged with constructive notice of the limits of that authority. *Herbert v. Langhoff*, 185 La. 105, 168 So. 508 (1936).

208. La. Civ. Code art. 2295.

accounting<sup>209</sup> in the absence of an agreement to the contrary.<sup>210</sup> The operator must exercise due diligence in accounting for the nonoperator's funds, including maintaining the necessary receipts.<sup>211</sup> Initially, the burden is upon the nonoperator to show the property or funds delivered to the operator and, upon proof thereof, shifts to the nonoperator to establish what disposition has been made of the funds.<sup>212</sup>

Significantly, an operator who uses the nonoperator's funds for unintended purposes may be liable to the nonoperator not only for a return of the funds but for any profits derived therefrom.<sup>213</sup> Where the operator has failed or refused to use the nonoperator's funds for the intended purpose, and then becomes insolvent, the nonoperator should be able to recover those funds so long as they can be identified.<sup>214</sup> If the funds have been commingled in the operator's general account and cannot be identified, the nonoperator may be relegated to the status of an unsecured creditor, although there is some authority for requiring the funds to be returned to the nonoperator on a constructive trust theory.<sup>215</sup> Case law suggests that the nonoperator can recover funds improperly paid to a third party creditor of the operator only where said creditor participated in or benefited from the operator's fraud.<sup>216</sup>

## 2. *Compensation or Set-off*

### a. *In General*

Where the operator and nonoperator each owe the other money, compensation, which is identical to the common law concept of set-off,<sup>217</sup> may take place.<sup>218</sup> Compensation occurs by operation of law where

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209. *Id.* art. 3004.

210. See *Caddo Oil Co. v. O'Brien*, 908 F.2d 13, 17 (5th Cir. 1990) (prudent operator standard in agreement negated fiduciary duty to render an accounting).

211. See *Succession of Desorme*, 10 Rob. 474 (La. 1845); *Gilmore v. Gilmore*, 137 La. 162, 68 So. 395 (1915).

212. See *Hodson v. Hodson*, 292 So. 2d 831 (La. App. 2d Cir.), writ denied, 295 So. 2d 177 (1974).

213. See La. Civ. Code art. 3005; *Foreman v. Pelican Stores*, 21 So. 2d 64 (La. App. 2d Cir. 1944).

214. See *Bloodworth v. Jacobs*, 2 La. Ann. 24 (1847); *Stetson, Avery & Co. v. Gurney*, 17 La. 162 (1841).

215. Compare *In re Mahan & Rowsey, Inc.*, 817 F.2d 682 (10th Cir. 1987) (nonoperator entitled to lowest balance in comingled account) and *Boyd v. Martin Exploration Co.*, 56 B.R. 776 (E.D. La. 1986) with *Marple v. Kurzweg*, 902 F.2d 397 (5th Cir. 1990); *Unimobil 84, Inc. v. Spurney*, 797 F.2d 214 (5th Cir. 1986) and *In re Latham Exploration Co., Inc.*, 83 B.R. 423 (W.D. La. 1988).

216. *Boisdore v. Bridgeman*, 502 So. 2d 1149, 1155 (La. App. 4th Cir. 1987) (knowing participation in fraudulent scheme); *Dohm v. O'Keefe*, 458 So. 2d 964 (La. App. 4th Cir.), writ denied, 460 So. 2d 1046 (1984).

217. *In re Delta Energy Resources, Inc.*, 67 B.R. 8, 10 (Bankr. W.D. La. 1986).

218. See La. Civ. Code art. 1893.

two persons owe each other sums of money that are equally liquidated and demandable.<sup>219</sup>

The jurisprudence offers various explanations of a liquidated claim, including those whose correctness is admitted by the debtor and those for a sum certain or an amount capable of ascertainment by mere calculation in accordance with accepted legal standards.<sup>220</sup> In *Sims v. Hays*,<sup>221</sup> the court held that a disputed debt was not liquidated where its proof could be along and laborious process.

### b. Bankruptcy

The Bankruptcy Code does not affect the right provided by state law for either an operator or nonoperator to set-off amounts owed to the debtor against the amounts owed by the debtor.<sup>222</sup> The automatic stay does not defeat the set-off but simply stays it pending an examination of the debtor's and the creditor's rights.<sup>223</sup> In *In re Wilson*,<sup>224</sup> the court held that: (a) an operator could exercise its lien rights by applying the nonoperator's pre-bankruptcy production proceeds to satisfy its pre-bankruptcy operating expenses; (b) the operator could not use post-petition production to offset the debtors' pre-petition obligations; (c) while set-off could take place post-petition, its applicability would be determined by the state law of co-tenancy until the operating agreement, an executory contract, is accepted; and (d) the portion of the proceeds that were royalty revenues, as distinguished from working interest revenues, could not be set off against expenses.

### 3. Liens

The operator has a contract action to recover the reasonable costs incurred in connection with operations in which the nonoperator participated.<sup>225</sup> However, absent agreement to the contrary, the mere failure

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219. See *United States Fidelity & Guar. Co. v. South Excavation, Inc.*, 480 So. 2d 920 (La. App. 2d Cir. 1985), writ denied, 481 So. 2d 1337 (1986); *Sliman v. Mahtook*, 136 So. 749 (La. App. 1st Cir. 1931). Debts are equally demandable when they are both mature and subject to payment on demand. *FDIC v. Page*, 195 So. 629 (La. App. 2d Cir. 1940).

220. *Reynaud v. His Creditors*, 4 Rob 514 (1843) (correctness admitted); *Coburn v. Commercial Nat'l Bank*, 453 So. 2d 597 (La. App. 2d Cir.), writ denied, 457 So. 2d 681 (La. 1984) (sum certain or capable of ascertainment); *Olinde Hardware & Supply Co. v. Ramsey*, 98 So. 2d 835 (La. App. 1st Cir. 1957). See also *Sims*, 521 So. 2d 730 (general discussion of liquidated debt).

221. 521 So. 2d 730 (La. App. 2d Cir. 1988).

222. 11 U.S.C.A. § 553(a) (1979); *In re Donato*, 17 B.R. 708 (Bankr. E.D. Va. 1982); *In re Haffner*, 12 B.R. 371 (Bankr. M.D. Tenn. 1981).

223. *In re Terry*, 7 B.R. 880 (Bankr. E.D. Va. 1980).

224. 69 B.R. 960 (Bankr. N.D. Tex. 1987).

225. See, e.g., *Exchange Oil & Gas Corp. v. Great Am. Exploration Corp.*, 789 F.2d 1161 (5th Cir. 1986); *Sterling v. McKendrick*, 134 So. 2d 655 (La. App. 4th Cir. 1961).

to pay a proportionate share of the well costs does not cause the nonoperator to forfeit his interest in the well. The operator is faced with the tedious task of filing suit, obtaining a money judgment, and then seeking to execute upon it while the nonoperator receives the production revenues.

Many operating agreements provide for a lien to run in favor of the operator or the nonoperator. Any such language ordinarily will be superfluous because in Louisiana liens are *stricti juris*, applying only where, and to the extent, authorized by statute.<sup>226</sup> Thus, courts generally must look not to the operating agreement, but to the Louisiana Oil, Gas and Water Wells Lien Act, which grants a lien in favor of anyone who performs any labor or service or furnishes supplies in connection with any oil, gas or water well.<sup>227</sup> On the theory that he performs a service, the operator has the right to a lien on the nonoperator's share of the mineral lease for the unpaid share of costs owed by the nonoperator.<sup>228</sup> Similarly, whether a nonoperator is entitled to a lien upon the operator's interest probably will depend upon whether the nonoperator is considered to have performed a service.<sup>229</sup>

To perfect a lien under the Act, notice of the lien must be filed in the public records where the well was drilled within 180 days of the last service performed, and suit must be brought on the claim within one year of recordation of said notice.<sup>230</sup> The lien may be enforced by a writ of sequestration without posting a bond.<sup>231</sup> Attorney's fees are recoverable in an action to enforce a lien.<sup>232</sup>

#### 4. Security Interests

Louisiana has recently adopted article 9 of the Uniform Commercial Code, making it easier for parties to an operating agreement to grant a security interest in production equipment and production to secure the performance of their obligations. A security interest attaches when: (a) there is a security agreement<sup>233</sup> signed by the debtor or containing a description of the property, (b) value has been given, and (c) the

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226. E.g., *Blazingame v. Anderson*, 236 La. 505, 108 So. 2d 105 (1959).

227. La. R.S. 9:4861 (1991).

228. *Blazingame v. Anderson*, 236 La. 505, 108 So. 2d 105 (1959); *Kenmore Oil Co. v. Delacroix*, 316 So. 2d 468 (La. App. 1st Cir. 1975).

229. In *Transworld Drilling Co. v. Texas Gen. Petroleum Co.*, 524 So. 2d 215 (La. App. 4th Cir. 1988), the court held that the validity of a nonoperator's lien is a mixed question of law and fact.

230. La. R.S. 9:4862, 9:4865 (1991).

231. *Id.* 9:4866.

232. *Caddo Oil Co. Inc. v. O'Brien*, 908 F.2d 13, 17 (5th Cir. 1990).

233. A security agreement is an agreement which creates or provides for a security interest. La. R.S. 10:9-105(1)(L) (Supp. 1992).

debtor has rights in the collateral.<sup>234</sup> The security interest is perfected by filing a financing statement<sup>235</sup> in the parish where the well is located.<sup>236</sup> Oil and gas reduced to possession may be so encumbered so long as the financing statement contains a legally sufficient description of the land from which the production occurs.<sup>237</sup> Once the production is sold, the creditor's security interest ceases to be perfected ten days after the debtor receives the proceeds unless they remain identifiable.<sup>238</sup>

### 5. *Litigation*

In the absence of an agreement to the contrary, actions arising out of a breach of an operating agreement must be brought within ten years.<sup>239</sup> However, operating agreements sometimes shorten this prescriptive period.<sup>240</sup> Louisiana courts consistently have upheld agreements that shorten the statutory period for bringing claims.<sup>241</sup> Absent fraud or a contractual provision, attorney's fees are not recoverable by the prevailing party.<sup>242</sup>

## V. CONCLUSION

Co-ownership, unitization, and operating agreements each substantially affects the right to conduct oil and gas operations, the liability for their costs and the right to the profits from them. Although each category of joint oil and gas operation carries with it different rights and liabilities, certain generalizations apply to all. The right to conduct operations depends upon property rights unless the property rights at issue have been modified by unitization or agreement. The person who conducts the operations has, at a minimum, the right to recover his costs out of production before anyone else can share in the profits therefrom. The right to recover costs in advance of production varies depending upon whether co-ownership, unitization or agreements are involved. Once costs have been recovered, each owner has the right to

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234. *Id.* 10:9-203.

235. *Id.* 10:9-402.

236. See *id.* 10:9-401, 10:9-402 & comments.

237. *Id.* 10:9-402(5).

238. See *id.* 10:9-301(1), 10:9-306(3).

239. *Caddo Oil, Inc. v. O'Brien*, 908 F.2d 13 (5th Cir. 1990).

240. *Exxon Corp. v. Crosby-Mississippi Resources, Ltd.*, 775 F. Supp. 969 (S.D. Miss. 1991); *Woods Petroleum Corp. v. Hommell*, 784 P.2d 242 (Wyo. 1989) (operating agreement required suit to be brought within two years).

241. *Caddo Oil*, 908 F.2d 13; see also *Con-Plex Div. of U.S. Indus., Inc. v. Vicon, Inc.*, 448 So. 2d 191 (La. App. 1st Cir. 1984); *Green v. Peoples Benev. Indus. Life Ins. Co. of La.*, 5 So. 2d 916 (La. App. 2d Cir. 1941).

242. See La. Civ. Code art. 1958; see also *Austin v. Parker*, 672 F.2d 508 (5th Cir. Unit A 1982).

share in production, either by in kind partition or, under certain circumstances, by cash balancing for gas production.

The Risk Fee Statute was a step in the right direction in rewarding operators who take risks in drilling unit wells. The same step should be taken in the area of co-ownership of mineral leases.

This article should familiarize the practitioner with the various legal problems that can arise when two or more parties control or participate in oil and gas operations. Despite the frequency with which such operations occur, the law is unsettled in many respects. The interplay between the statutes, the jurisprudence, the custom in the industry, and equity creates interesting legal issues as well as opportunities for creative lawyers. Recognition of the legal problems inherent in such operations is the first step toward their solution.



